

SECURITIES AND EXCHANGE COMMISSION
Release No. 34-88037; File No. SR-FINRA-2020-002

January 24, 2020

Self-Regulatory Organizations; Financial Industry Regulatory Authority, Inc.; Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Amend FINRA Rule 11900 to Except Certain Transactions in Corporate Debt Securities

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)¹ and Rule 19b-4 thereunder,² notice is hereby given that on January 17, 2020, Financial Industry Regulatory Authority, Inc. (“FINRA”) filed with the Securities and Exchange Commission (“SEC” or “Commission”) the proposed rule change as described in Items I, II, and III below, which Items have been prepared by FINRA. FINRA has designated the proposed rule change as constituting a “non-controversial” rule change under paragraph (f)(6) of Rule 19b-4 under the Act,³ which renders the proposal effective upon receipt of this filing by the Commission. The Commission is publishing this notice to solicit comments on the proposed rule change from interested persons.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

FINRA is proposing to amend Rule 11900 (Clearance of Corporate Debt Securities) to except certain transactions in corporate debt securities.

The text of the proposed rule change is available on FINRA’s website at <http://www.finra.org>, at the principal office of FINRA and at the Commission’s Public Reference Room.

¹ 15 U.S.C. 78s(b)(1).

² 17 CFR 240.19b-4.

³ 17 CFR 240.19b-4(f)(6).

II. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, FINRA included statements concerning the purpose of and basis for the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item IV below. FINRA has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization’s Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

Rule 11900 under FINRA’s Uniform Practice Code (the “Rule”) sets forth members’ obligations with respect to the use of a registered clearing agency (a “clearing agency”) to clear over-the-counter transactions in corporate debt securities.⁴ Specifically, the Rule requires that a member or its agent that is a participant in a clearing agency must use the facilities of a clearing agency to clear eligible transactions between members in corporate debt securities executed over the counter.⁵ The Rule is intended to reduce or eliminate the risks and inefficiencies associated with broker-to-broker clearing in transactions in corporate debt securities, including trade fails and potential financial exposure.⁶ When FINRA (then NASD) adopted this requirement in 1995, NASD noted

⁴ See Rule 11900, available at <https://www.finra.org/rules-guidance/rulebooks/finra-rules/11900>.

⁵ Section 17A of the Exchange Act and Rule 17Ab2-1 thereunder require entities to register with the Commission prior to performing the functions of a clearing agency. See 15 U.S.C. 78q-1; see also 17 CFR 240.17Ab2-1.

⁶ See Securities Exchange Act Release No. 35769 (May 25, 1995), 60 FR 28814 (June 2, 1995) (Order Approving File No. SR-NASD-95-11).

that there was a large percentage of corporate debt transactions cleared and settled broker-to-broker without using the facilities of a clearing agency, and that this process was error prone and time- and labor-intensive.⁷ These inefficiencies increased systemic clearance risk for members.⁸

FINRA is proposing to amend the Rule to provide an exception for over-the-counter transactions between members (the “parties”) where the same member (the “carrying member”) is clearing and settling both the purchase and the sale side of a transaction in a corporate debt security, and where such clearance and settlement occurs through book-keeping transfers between the parties’ accounts at the carrying member. Where the same carrying member is the clearing firm for both sides of the transaction, the seller’s delivery and the buyer’s receipt of the corporate debt security can be effected exclusively through book-keeping transfers between the parties’ accounts at the carrying member, resulting in no net settlement obligation to or from a clearing agency. Further, where there is no net settlement obligation, the risks and inefficiencies that the Rule is intended to protect against (e.g., trade fails) are not present, and the use of a clearing agency to clear the transaction provides no additional benefit while nonetheless incurring costs for the carrying member.⁹ FINRA is, therefore, proposing the instant exception and

⁷ See Securities Exchange Act Release No. 35642 (April 24, 1995), 60 FR 21226 (May 1, 1995) (Notice of Filing of File No. SR-NASD-95-11) (“Original Proposal”).

⁸ See supra note 7.

⁹ The exception would apply only where the carrying firm internalizes the clearance of the transaction. Thus, the proposed exception would not apply to a transaction in which a member is clearing only the purchase or the sale side of a transaction.

believes that it is appropriate because the intended benefits of the Rule—i.e., to reduce or eliminate the risks and inefficiencies associated with broker-to-broker clearing—do not exist for transactions that do not result in a net settlement obligation on the clearing firm level.¹⁰ The proposed exception is limited to transactions where a carrying member clears for both the buyer and the seller in a transaction (i.e., where an obligation to deliver securities to, or receive securities from, a third party is not created with respect to the individual transaction).

FINRA has filed the proposed rule change for immediate effectiveness. The proposed rule change will become operative 30 days after the date of filing.

2. Statutory Basis

FINRA believes that the proposed rule change is consistent with the provisions of Section 15A(b)(6) of the Act,¹¹ which requires, among other things, that FINRA rules must be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest.

FINRA notes that the proposed exception would not alter counter-party clearing risks, such as financial exposure, because where a member or its agent utilizes the exception provided for under this proposal, it would serve as the central party on both the

¹⁰ While the current Rule provides FINRA with authority to exempt any transaction or class of transactions to accommodate special circumstances related to the clearance of such transactions or class of transactions, we do not believe that this authority is well suited to the proposed exception. See Rule 11900. Because FINRA is seeking to provide an exception for a broad class of transactions, FINRA believes it is appropriate to provide the proposed exception as an amendment to the Rule.

¹¹ 15 U.S.C. 78o-3(b)(6).

purchase and the sale side of the transaction and would clear and settle the transaction internally through book-keeping transfers. As such, no net settlement obligation would be created on the level of the clearing firm, and the risks and inefficiencies that the Rule is intended to protect against would not be present. Thus, FINRA believes the proposed rule change strikes an appropriate balance between providing relief uniformly to members where the Rule does not provide the intended benefits, while preserving the protections of the Rule for all other eligible transactions between members in corporate debt securities executed over the counter. Accordingly, FINRA believes the proposal promotes just and equitable principles of trade, and protects investors and the public interest.

B. Self-Regulatory Organization's Statement on Burden on Competition

FINRA does not believe that the proposed rule change will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed exception would apply uniformly where the same carrying member clears and settles both the purchase and the sale side of a transaction in a corporate debt security through book-keeping transfers between the parties' accounts at the carrying member. FINRA discussed the proposed exception with its Uniform Practice Code and Fixed Income Committees, who supported the proposed amendment. FINRA also discussed the proposal with SIFMA's Clearing Firms Committee, which also supported the proposal.

Economic Impact Assessment

Regulatory Need

Under Rule 11900, each member or its agent that is a participant in a clearing agency is required to send eligible over-the-counter transactions between members in corporate debt securities to a clearing agency for clearing. For transactions where the same carrying member is clearing both the purchase and sale side of the transaction, the funds and the securities are reflected in each party's account at the carrying member. Thus, the clearing of such transactions can be done effectively through book-keeping transfers between the parties' accounts at the carrying member, without sending the transaction for central clearing. Specifically, because no net settlement obligation is created between the carrying member and the clearing agency for such transactions, clearing these transactions through a clearing agency does not provide the additional benefits of reducing or eliminating the risks and inefficiencies that central clearing usually provides.

However, while the current rule requiring carrying members to clear these transactions through a clearing agency does not provide the benefits that the rule was designed to provide (e.g., mitigating counterparty risk), it nonetheless results in members incurring the costs associated with submitting these transactions for central clearing. Under the proposed amendment, carrying members would no longer be required to use the facilities of a clearing agency for clearing such transactions, and may choose to internalize the clearing and settlement of these transactions and avoid the fees that would be imposed by the clearing agency.

Economic Baseline

Currently, each member or its agent that is a participant in a clearing agency is required under Rule 11900 to send eligible over-the-counter transactions between

members in corporate debt securities to a registered clearing agency for clearing and settlement. The National Securities Clearing Corporation (NSCC), a subsidiary of The Depository Trust & Clearing Corporation (DTCC), provides central clearing services for corporate debt securities, among other products. According to NSCC's website calculator, clearing fees consist of three parts: a tiered "clearance fee" based on the number of trades; a "value into net fee" based on the total value traded; and a "value out of net fee" based on the value that does not get netted.¹²

Economic Impacts

When internally clearing a transaction, the delivery of the corporate debt security and money by the respective parties to settle a transaction can be effected through book-keeping transfers between the buyer's and seller's accounts at the carrying member. Under the proposed exception, carrying members would be able to avoid the clearing costs imposed by the clearing agency while continuing to clear and settle the transaction on behalf of both counterparties. Potential savings from internalizing the clearance of these transactions may or may not be passed on to the customers of the carrying member. FINRA notes that these potential cost savings are not at the expense of losing the benefits offered by clearing agencies, namely mitigating counterparty risk and increasing efficiency. This is because, when the same carrying firm is clearing for both the buy and sell side of a transaction, counterparty risk is not inherently present as no net settlement obligation to or from the carrying member is created. Therefore, by permitting members

¹² See NSCC Clearing Activity Monthly Fee Calculators, available at: <http://www.dtcc.com/forms/clearing-fee-calculator-new>.

to elect to clear these transactions internally, the buyers' and sellers' counterparty risk remains unchanged.

FINRA understands that internalizing the clearance of such transactions alone would not affect the clearing agency's margin calculation for a clearing firm availing itself of the exception. Based on a conversation with DTCC, margin is collected when there is a net debit after performing mark-to-market of the trades submitted. Therefore, when clearing firms choose to internalize the clearance of transactions that create no net settlement obligations, we understand that the margin required by the clearing agency is not changed.

When a carrying firm chooses to clear transactions internally, DTCC may lose revenues from the clearing fees collected from that firm (assuming the fee structure remains unchanged). NSCC generally charges lower clearing fees for transactions that can be netted out.¹³ Based on the 2014 NSCC calculator, the value fee (dollar per million traded) for clearing such transactions is 12.3% of the fee for clearing transactions that cannot be netted out.¹⁴

Competition and Efficiency

FINRA expects that the proposed amendment will improve the efficiency of the clearing process by removing a step that does not provide the intended benefit and allowing over-the-counter transactions in corporate debt securities that create no net settlement obligation to be internally cleared by the carrying firm, as described above. Carrying firms will potentially save on clearing costs for such transactions in

¹³ See supra note 12.

¹⁴ See supra note 12.

circumstances where central clearing would not provide the additional protections related to counterparty risks or improved efficiency over bilateral clearing that were envisioned at the time Rule 11900 was adopted.

Clearing firms that serve more customers engaging in eligible over-the-counter transactions in corporate debt securities likely may benefit more from the proposed exception. The percentage of such transactions that can be internalized may in turn be higher than that of smaller clearing firms. To the extent smaller firms have eligible transactions that may be internalized under the proposal, they also should benefit from the proposal should they choose to internalize clearing, where permitted, and avoid related central clearing costs.

Alternatives Considered

No alternatives were considered for this proposal.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

FINRA received an email from Pershing LLC ("Pershing") relating to the need for the proposed rule change.¹⁵ Pershing stated that, in submitting trades to NSCC where Pershing is clearing for both the buyer and the seller, there is no net risk mitigation because there is no net settlement obligation created. Further, Pershing stated that, by not submitting these specific transactions to NSCC, it would realize significant cost savings. As a result, Pershing requested that FINRA except from Rule 11900 the class of transactions for which a member is the clearing firm for both the buyer and the seller, to allow it to clear those transactions internally. Pershing specified that it was not

¹⁵ See Exhibit 2.

requesting relief for any transaction in which a counterparty clears at an NSCC Participant other than Pershing. FINRA believes that the instant proposal provides the narrow relief that Pershing requested, and notes that the exception would be available to all members that meet the requirements of the exception. As discussed above, FINRA believes the proposed rule change strikes an appropriate balance between providing relief uniformly to members where the Rule does not provide the intended benefits, and preserving the protections of the Rule for all other eligible transactions between members in corporate debt securities executed over the counter.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Because the foregoing proposed rule change does not: (i) significantly affect the protection of investors or the public interest; (ii) impose any significant burden on competition; and (iii) become operative for 30 days from the date on which it was filed, or such shorter time as the Commission may designate, it has become effective pursuant to Section 19(b)(3)(A) of the Act¹⁶ and Rule 19b-4(f)(6) thereunder.¹⁷

At any time within 60 days of the filing of the proposed rule change, the Commission summarily may temporarily suspend such rule change if it appears to the Commission that such action is necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Act. If the Commission takes such action, the Commission shall institute proceedings to determine whether the proposed rule should be approved or disapproved.

¹⁶ 15 U.S.C. 78s(b)(3)(A).

¹⁷ 17 CFR 240.19b-4(f)(6).

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number SR-FINRA-2020-002 on the subject line.

Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-FINRA-2020-002. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10 a.m. and 3

p.m. Copies of such filing also will be available for inspection and copying at the principal office of FINRA. All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-FINRA-2020-002 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.¹⁸

J. Matthew DeLesDernier
Assistant Secretary

¹⁸ 17 CFR 200.30-3(a)(12).